

# TaxTalk

## RESEARCH AND DEVELOPMENT

### Introduction

Canadian businesses compete on a global basis. An important factor in the competitiveness of Canadian businesses is the expenditure of funds on research and development (R&D)<sup>1</sup>. The federal and provincial governments provide a number of income tax incentives to businesses that engage in R&D in Canada - Canada's tax incentives for R&D are among the most generous in the world. Unfortunately, many Canadian businesses are not taking full advantage of these incentives, since, for the most part, they are unaware that they are conducting eligible R&D activities, or they are intimidated by the filing and record-keeping necessary to make a successful R&D claim.

This issue of TaxTalk defines what R&D is, explains the federal and Ontario tax incentives, and briefly discusses how R&D is claimed on tax returns. If you feel that your business, whether operated as a corporation or individually as a sole proprietor, may be engaged in R&D, you should seek professional advice to determine the tax benefits potentially available and how to make a claim.

### What is R&D?

R&D is defined for income tax purposes as a "systematic investigation or search carried out in a field of science or technology by means of experiment or analysis". It is important to note that the definition of R&D for tax purposes is much broader than the scientific definition. R&D for tax purposes does not need to be either

carried out in a laboratory or carried on by scientists.

For income tax purposes, R&D must be one of the three following activities:

1. **Basic Research** - work undertaken for the advancement of scientific knowledge without a specific practical application in view;
2. **Applied Research** - work undertaken for the advancement of scientific knowledge with a specific practical application in view; **or**
3. **Experimental Development** - the use of basic or applied research in creating new, or improving existing, materials, devices, products, or processes.

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<sup>1</sup> The Income Tax Act of Canada refers to research and development as "Scientific Research and Experimental Development".

**R&D includes supporting activities** such as work undertaken with respect to engineering, design, mathematical analysis, computer programming, data collection, testing, and other activities when such work is commensurate with the needs, and directly in support of, the work noted for basic and applied research and experimental development.

The following activities do not qualify as R&D for income tax purposes:

- Market research or sales promotion;
- Quality control and routine testing of material, devices, products or processes;
- Research in the social sciences or the humanities;
- Prospecting, exploring or drilling for or producing minerals, petroleum or natural gas;
- Commercial production of a new or improved material, device or product or the commercial use of a new or improved process;
- Style changes, and
- Routine data collection.

Keep in mind that there is a distinction between market research and product research. Activities associated with product research are eligible for R&D treatment while activities related to market research are **not** eligible for R&D.

**Three criteria** are used to determine whether the definition of R&D is satisfied in each particular case. All three criteria must be satisfied in order for expenditure to qualify as R&D.

1. **The Criterion of Scientific or Technological Advancement** requires that the R&D activities relate to a technological advancement in the standard practice of the business entity carrying out the activities.

2. **The Criterion of Scientific or Technological Uncertainty** requires that there be a technological uncertainty facing the business entity carrying out the activities. In particular, one of the following two conditions must be satisfied:

- it is uncertain whether the goals can be achieved at all; **or**
- there is confidence that the goals can be achieved, but there is uncertainty as to which of several alternatives (i.e., paths, routes, approaches, equipment configurations, system architectures, circuit techniques, etc.) will either work at all, or be feasible in order to meet the desired specifications and/or cost targets.

3. **The Criterion of Scientific and Technical Content** requires that **both** of the following conditions be met:

- the objectives of the R&D activities must be clearly stated at an early stage in the project's evolution; the method of experimentation or analysis by which the scientific or technological uncertainties are to be addressed must be clearly set out; and the results of the subsequent R&D efforts must be properly identified, **and**
- qualified personnel having relevant experience in science, technology or engineering must be responsible for the direction or performance of the work.

The existence of scientific or technological uncertainty is important in determining if R&D expenditures are eligible activities. Sometimes there is little doubt that a product or process can be achieved to meet technological objectives when cost targets are no object. In commercial reality, however, a reasonable cost target is always an objective, and attempting to achieve a particular cost target can, at times, create a technological challenge which needs to be resolved. Thus, a technological uncertainty may arise as a result of economic considerations.

## What are the Tax Incentives for R&D?

### Overview

The federal and Ontario governments provide separate, but interrelated, incentive programs related to R&D. Both programs have two components:

- first, R&D expenditures can be deducted, either more quickly or in a larger amount, than other expenditures,
- secondly, investment tax credits<sup>2</sup>, all or partly refundable, can be earned.

There are three income tax incentives that may be available to a company with respect to its R&D expenditures. They are as follows:

1. Federal investment tax credit;
2. Ontario innovation tax credit; and
3. Full deduction of capital R&D expenditures

In addition to these incentives, Ontario does not require a reduction in the Ontario Current and Capital Expenditure Pool<sup>3</sup> for federal investment tax credits earned on Ontario R&D expenditures. Initially this measure was only to apply for a two year period beginning with tax years that commenced after 2000. However, the two year period has passed and Ontario has not changed its rules, therefore, the federal investment tax credit still does not reduce the Ontario Current and Capital Expenditure Pool.

The R&D incentives are more generous for a “small” Canadian controlled private corporation (CCPC)<sup>4</sup>. A small CCPC is not a defined term, but the reference herein to a ‘small CCPC’ will refer to a CCPC that has taxable income in a year

<sup>2</sup> Investment tax credits generally reduce taxes payable. Refundable investment tax credits create a tax refund when no income tax is otherwise payable.

<sup>3</sup> The federal tax rules require the R&D expenditure pool to be reduced by the investment tax credits claimed in a prior year. See the section on Current and Capital Expenditure Pool.

<sup>4</sup> A CCPC is defined in the Income Tax Act as a private corporation which is a Canadian corporation, other than a corporation which is controlled directly or indirectly in any manner whatever by one or more non-resident persons, by one or more public corporations or by any combination thereof. For instance, if a non-resident of Canada controls the company, it would NOT be a CCPC.

less than \$500,000 and taxable capital less than \$15 million.

### R&D Deductions

In general, a taxpayer is allowed an immediate deduction for “**current**” R&D expenditures, which include all labour, materials and certain overhead costs (unless the taxpayer elects to use the proxy method discussed below) related to their R&D activities. In addition, the cost of certain **capital expenditures** devoted to R&D can also be written off in the current year. If an immediate deduction is not desired, the taxpayer may choose to defer deducting these costs until a future year. (See discussion on Current and Capital Expenditure Pool below).

### Current Expenditures

The following **current** expenditures are eligible for R&D treatment:

- 1) The R&D portion of salaries, wages and related benefits of employees directly engaged in R&D activities. If any of these employees are specified employees<sup>5</sup> of the company, their salaries and wages (except for bonuses based on profit which are **not** eligible) have to be reported separately, and are subject to certain restrictions.
 

Bonuses paid to specified employees that are based on profit do not qualify as R&D.
- 2) Materials and supplies consumed in the prosecution of R&D.
- 3) Amounts paid to contractors and subcontractors performing R&D on behalf of the company.
- 4) The lease cost of certain equipment used in conducting R&D.
- 5) Overhead expenses are considered to be expenditures in support of R&D activities and are:
  - a) directly attributable to R&D or
  - b) directly related to the supply of premises, facilities or equipment for performing R&D.

<sup>5</sup> Specified employees include those employees who do not deal at arm’s length with the employer or own, directly or indirectly, 10% or more of the shares of the employer.

Overhead expenses include an allocation of salary and wages of employees who supervise or support R&D activities, related employee benefits, travel, training, etc. Overhead expenses related to R&D that are going to be included in the current expenditure pool must be identified and the method used to allocate the costs must be reasonable and based on a relevant basis such as square footage of premises used for R&D.

Eligible R&D expenditures also include payments made to approved third parties<sup>6</sup> who conduct R&D activities carried out in Canada that are related to the business of the company pursuant to an agreement whereby the company is entitled to exploit the results of the R&D.

### Capital Expenditures

As indicated above, in addition to the deduction for current expenses, a company incurring R&D expenditures can choose to **fully deduct** qualifying<sup>7</sup> **capital expenditures** in the year incurred or in any future year where: the property acquired is for scientific research carried on in Canada, related to the taxpayer's business, and directly undertaken by or on behalf of the taxpayer. Generally only capital expenditures on **new** and not used equipment are allowable.

### Current and Capital Expenditures Pool

All current and qualifying capital expenditures are accumulated in a total R&D pool. The amount in the R&D pool can be deducted in any amount in any (current or future) year. This provides flexibility to taxpayers in two ways: first, capital expenditures, that would otherwise be capitalized and depreciated over a number of years, can be fully deducted in the current year for income tax purposes, and secondly, current expenditures, which would otherwise have to be deducted in the current year, may be deferred (indefinitely) for businesses that are in a loss

position and do not want to claim the expenditure currently.<sup>8</sup>

The **R&D expenditure pool is reduced** by any incentives received from government and non-government sources. These incentives include grants, the *prior* year's federal investment tax credit claims on current expenditures, and the *current* year's Ontario Innovation Tax Credit claims (excluding the proxy portion until the subsequent year). The R&D pool is also reduced by the proceeds of sale of R&D capital assets.

Certain expenditures are not considered R&D expenditures and are not eligible for the investment tax credit. These include certain administrative salaries or wages and related benefits for a person whose duties are not at least 90% for R&D purposes, legal or accounting fees, interest and other financing costs, entertainment expenses, advertising or selling expenses, convention expenses, dues or fees for membership in a scientific or technical society or organization, fines or penalties and any outlay or expense incurred for the use of or right to use a building.

### Investment Tax Credits

Investment tax credits (ITC) represent a second major tax incentive available in respect of R&D expenditures. These tax credits are available to reduce taxes payable, and can create cash refunds to eligible R&D taxpayers.

### Federal Investment Tax Credits

Taxpayers engaged in R&D can obtain federal ITCs on qualifying R&D expenditures. These ITCs can reduce or eliminate federal taxes otherwise payable, or, in the case of a 'small' CCPC, the ITCs can be wholly or partly refundable in cash.

The rules/rates are complex and depend on the income and capital of the company. The ITC rates are either 20% or 35% of qualifying R&D expenditures. The higher 35% rate can apply to small CCPCs and any associated corporations<sup>9</sup>

<sup>6</sup> CCRA has a list of approved institutions and associations that carry on R&D activities.

<sup>7</sup> The following capital expenditures do not qualify for a current deduction: land, a leasehold interest in land, a building or a right to use existing technology.

<sup>8</sup> R&D expenditures are not limited to the 7 year carry forward which normally applies to non-capital losses.

<sup>9</sup> In general, companies are associated if there is common ownership or control, pursuant to specific rules of the Income Tax Act.

with aggregate taxable income not in excess of \$200,000<sup>10</sup> and aggregate taxable capital not in excess of \$10 million.

The 35% rate is gradually reduced down to the 20% rate, where either taxable income of the associated group in the *previous* year exceeds \$200,000<sup>11</sup> or taxable capital of the associated group in the *previous* year exceeds \$10 million. The 35% ITC rate is fully reduced to 20% where either taxable income of the associated group in the previous year is \$400,000<sup>12</sup> or more, or taxable capital of the associated group is \$15 million or more.

Further, where the 35% ITC rate applies, it is limited to no more than \$2 million of qualifying scientific research expenditures made in the year by the corporation and its associated companies.<sup>13</sup> The expenditures that qualify for the 35% ITC must be allocated among associated companies. Any R&D expenditure that does not qualify for the 35% rate will qualify for the general 20% rate.

For a small CCPC, a **refundable ITC** may be available. To the extent that the ITC reduces federal tax to zero, either 100% or 40% of the unclaimed ITC may be claimed as a cash refund. A 100% refund is available on ITCs on current expenditures calculated at the 35% rate. A 40% refund is available on ITCs calculated at the 20% rate as well as all ITCs on capital expenditures.

Expenditures on capital equipment that are used 90% or more for R&D purposes will be eligible for the full ITC. The ITC will be limited for capital equipment that is used more than 50%, but less than 90%, of the time for R&D purposes.<sup>14</sup>

<sup>10</sup> The income threshold is based on taxable income of the previous year rather than the current year.

<sup>11</sup> The income threshold was increased from \$200,000 to \$300,000 in the 2003 federal budget. Since the threshold is determined from the previous year's taxable income, the \$300,000 will generally start to apply to 2004 year ends.

<sup>12</sup> The income threshold where the 35% rate will disappear will increase from \$400,000 to \$500,000, with the increase generally applicable starting in 2004 year ends.

<sup>13</sup> The annual \$2 million expenditure threshold is reduced where taxable income exceeds \$200,000 or taxable capital exceeds \$10 million.

<sup>14</sup> In this case, the limitation on the ITC is 25% of the normal ITC in each of the first two years, provided that the equipment is used more than 50% of the time for R&D activities in each year.

Any ITC earned in the current year and still remaining, after the maximum amounts are claimed as a credit against the current year's federal tax and/or claimed as a cash refund, can be carried back three years and forward ten years and claimed as a credit against Part I federal tax in those carryover years.

An ITC that is claimed, either as a credit against federal tax or as a cash refund, must be included in the company's federal taxable income in the year subsequent to the year in which the ITC is claimed, and is subject to tax at the appropriate corporate tax rate in that year. For years commencing after 2000, the federal ITC is **not** included in Ontario taxable income.

The attached *Tables 1 and 2* provide more detailed information concerning ITC rates and refundable ITC rates.

### ***Proxy Method for Overhead Expenses***

In calculating R&D expenditures for which an ITC can be claimed,<sup>15</sup> taxpayers can elect to use the "Proxy Method." The proxy method is an alternative method that uses a notional overhead amount rather than identifying and allocating specific overhead expenses that relate to R&D activities. If this method is selected, 65% of the amount of direct salaries and wages included in current R&D expenditures will qualify for R&D ITCs. The notional amount is limited, and cannot exceed the taxpayer's total actual overhead expenses.

When the proxy method is used, the taxpayer cannot claim actual overhead costs as R&D expenditures when determining the tax deduction or the ITCs (i.e., actual overhead expenses would be deducted as regular business expenses).

The proxy method is primarily beneficial to smaller companies that have a mix of R&D and other activities, and thus have the most difficulty in identifying some of their administrative costs as R&D under the general rules. It can lead to higher tax savings where the R&D activities are labour intensive (since it is based on direct R&D salaries/wages) or where the actual overhead related to R&D is low.

<sup>15</sup> The proxy amount is used only to compute overhead to compute the federal R&D ITC; it is not used to calculate current R&D expenditures.

### Ontario Innovative Tax Credit (OITC)

A refundable Ontario R&D tax credit, which is referred to as the OITC, is available on qualifying R&D expenditures.

The OITC is potentially available to public and private corporations that: (i) have a permanent establishment in Ontario; (ii) carry on scientific research and experimental development in Ontario in the year for which the credit is claimed; **and** (iii) are eligible, and file for, the federal R&D ITCs in the year with respect to R&D carried on in Ontario.

This tax credit is refundable in the year claimed and is calculated at the rate of 10% of all current R&D expenditures plus 40% of qualifying<sup>16</sup> capital R&D expenditures. If the credit reduces Ontario tax below zero, the excess can be claimed as a cash refund.

Similar to the federal ITC rates, there is a reduction in the OITC rates from 10% eventually to 0%. The OITC reduction occurs when either the taxable income of the associated group in the previous year exceeds \$200,000 or taxable capital of the associated group exceeds \$25 million.

The OITC is included in the company's taxable income<sup>17</sup> for both federal and Ontario income tax purposes in the year in which the credit is claimed, and is thus subject to tax at the appropriate corporate tax rate in that year.

### Tax Savings From R&D

The attached **Table 3** provides a comparison of the tax treatment of a \$100 expenditure in two cases: first, if the [current] expenditure does not qualify for R&D treatment, and secondly, if the expenditure does qualify for R&D treatment and the taxpayer elects to use the proxy method to compute federal ITCs. The table highlights the incentives that are discussed in greater detail above. As the table illustrates, the tax saved on a \$100 current R&D expenditure is approximately

<sup>16</sup> For OITC purposes qualifying capital expenditures include only new equipment.

<sup>17</sup> The OITC related to non-proxy overhead R&D amounts must be included in current year income. The OITC related to the proxy amount must be included in income in the following year.

\$35, based on the assumptions as indicated in the table.

### Claiming R&D

To make a successful R&D claim, it is essential that proper records are maintained and appropriate documents are filed with the taxation authorities to support the claim. The record keeping requirements can be onerous. The filing of a valid and complete R&D claim requires extensive documentation, including a detailed analysis of relevant costs. Most of the required documentation is to prove that a particular project does, in fact, qualify as R&D. The deadline to file a claim for R&D expenditures and the related ITC is 18 months after the end of the year-end to which the R&D expenditures relate.

*Form T661 - Claim for Scientific Research and Experimental Development (R&D) Expenditures Carried on in Canada* - must be completed and filed with the income tax return. The purpose and use of this form is to:

1. demonstrate that the three criteria of R&D are met, and substantiate the activities for which R&D expenditures are claimed.
2. show why each activity of the R&D project is required, and how the activity fits into the project as a whole.

*Schedule 031 - Investment Tax Credits - Corporations* - must be completed to claim federal ITCs. A narrative describing the R&D project(s) has to accompany Form T661. There is no provision to allow the forms to be late-filed and Canada Customs and Revenue Agency (CCRA) has taken a position that it will no longer accept forms where the information is not complete by the filing deadline.

The detail appropriate to any R&D claim will depend on the size of the taxpayer's organization and the amount of the claim. However, if there is no documentation or record to substantiate the R&D work, the claim will be rejected, and the expenses will be reclassified in accordance with the general scheme of the Income Tax Act. It is the taxpayer's responsibility to provide technical documentation and records adequate to support

their R&D claim. The taxpayer must be able to show that the claimed R&D activities are directly related to an R&D project.

The detailed project description is an important part of the submission and it is made up of answers to five specific questions on the form. The description should be written in a style suitable for a reviewer of CCRA, who is generally a scientist or engineer. The description should be confined to the relevant technical facts which illustrate the experimental nature of the work.

The five questions referred to above deal with: the objectives of the work, the technological advancement expected to be attained, the scientific or technological uncertainty that have to be resolved, a description of the work performed, and the technical documentation to support the R&D claim.

To establish whether or not the work claimed is eligible R&D, CCRA will examine each project separately from a scientific point of view. Thus, the information in the R&D claim showing the work done must be organized on a project by project basis.

Preparing the initial R&D claim will involve some time and preparation. However, once the initial claim has been submitted and subjected to audit by CCRA, subsequent claims become more straightforward.

For Ontario, two additional forms must be completed and filed to claim the Ontario R&D expenditure<sup>18</sup> and the OITC<sup>19</sup>. The deadline to file these forms is also 18 months after the end of the year-end to which the R&D expenditures relate.

### ***CCRA Advisory Services***

As the above discussion indicates, the record keeping and paper work required for a successful R&D claim can be onerous and intimidating.

CCRA recognizes this and offers several advisory services to taxpayers that are considering making an R&D claim. The

objective of these services is to help taxpayers make successful R&D claims and remove uncertainty as to whether a claim is eligible or not.

The **First-Time Claimant Service** is designed to assist businesses that are new to the R&D Program. The objective is to provide information, tools and assistance in completing the R&D claim.

The R&D **Preclaim Project Review Service (PCPR)** is designed to provide the following benefits:<sup>20</sup>

1. more up-front certainty about the eligibility of R&D projects;
2. an opportunity to receive a preliminary opinion, thus reducing claim preparation costs;
3. open and informal discussions about the eligibility of R&D projects;
4. a simpler way for companies to participate in the program; and
5. a faster method to receive R&D tax incentives.

The PCPR can occur when the R&D activity is underway or even prior to the initiation of the project. In many cases, the PCPR service is best performed when the project is in the planning stage. CCRA representatives meet with the taxpayer and his representatives to discuss the proposed project. Based on the information provided by the taxpayer, CCRA's representative will provide an opinion on the eligibility for R&D treatment of the project. The opinion will include an explanation of why the project is eligible or ineligible and what records will be required to support the claim.

For anyone unsure on whether or not their activities include an R&D component, the PCPR, as an up-front service, can be invaluable and can save much aggravation in accumulating the data to support an R&D claim.

<sup>18</sup> The CT23 Schedule 161 - Ontario Scientific Research and Experimental Development Expenditures form.

<sup>19</sup> The Ontario Innovation Tax Credit (OITC) Claim form.

<sup>20</sup> RC4271 - Introducing the SR&ED Program's Preclaim Project Review Service

### **CCRA Audit**

R&D claims are subject to extensive review and audit by CCRA especially the first time an R&D claim is submitted. The R&D administration function at CCRA is centred in two groups. The Scientific Research Section, composed of science advisors and technical consultants, provides the **scientific or technical** expertise necessary to determine the eligibility of work claimed for the R&D tax incentives. The Tax Incentive Audit Section, composed of auditors, provides the **financial** expertise to determine the eligibility of expenditures claimed for the R&D tax incentives or to service the needs of claimants.

R&D claims are first reviewed to determine if the documentation is complete. Once this hurdle is passed, the claims are reviewed by a Science Advisor or a Technical Consultant to verify that the underlying work meets the definition of R&D. If a PCPR is conducted the Science Advisor or Technical Consultant provides comments or an opinion as to whether the project meets the definition of R&D or how the project needs to be modified for it to qualify as R&D. The work claimed may be found to meet the R&D definition fully, partially or not at all.

Expenditures relating to eligible R&D are then subject to a financial review to assure the validity of the costs claimed. Depending on various criteria, claims may receive a limited review or undergo a complete audit. Auditors located in the various tax services offices across the country undertake the financial review.

R&D claimants have access to an appeals function, the purpose of which is to resolve claim disputes in an impartial, objective and timely manner.

### **Conclusion**

Many Canadian businesses are unaware that they are conducting R&D and, thus, are not realizing the tax incentives available. These incentives can significantly reduce the after-tax cost of R&D activities. R&D refunds can be a good source of cash for a start-up business that is carrying on R&D activities.

It would be a worthwhile exercise to review your business in order to identify those activities that may be R&D. As the above discussion highlights, the R&D rules can be extremely **complex** and there are **deadlines** for making the claim; thus professional advice should be obtained.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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## Table 1 - Investment Tax Credit Rates - Federal

The following table summarizes the different Investment Tax Credit (ITC) rates. The rates vary depending on:

- the nature of the taxpayer - CCPC, non-CCPC, individual
- For CCPCs, and any associated corporations - the aggregate taxable income and taxable capital of the group in the previous year.

Nature of Taxpayer	ITC Rate
<p>For CCPCs with taxable income of \$200,000<sup>21</sup> or less and taxable capital of \$10,000,000 or less; On current and capital expenditures included in the R&amp;D pool plus the proxy amount (if so elected)</p> <p style="text-align: center;">- Up to \$2,000,000 of R&amp;D expenditures made in the year.</p> <p>If taxable income is greater than \$200,000 in the preceding year, the 35% ITC rate is phased out.</p> <p>If taxable capital is greater than \$10,000,000 in the preceding year, the 35% ITC rate is phased out.</p> <p style="text-align: center;">Associated corporations must share the \$200,000, \$10,000,000 and the \$2,000,000 limits.</p> <p style="text-align: center;">With the limits, the annual ITC claim of an associated group of companies in a year cannot exceed \$700,000, or 35% of \$2,000,000.</p>	35%
<p style="text-align: center;">For CCPCs - on R&amp;D expenditures in excess of \$2,000,000 made in the year.</p> <p>For CCPCs with either taxable income of \$500,000 or more or taxable capital of \$15 million or more</p> <p>For all other corporations (non-CCPCs) and individuals carrying on R&amp;D activities in Canada.</p>	20%

## Table 2 - Refundable Investment Tax Credit Rates - Federal

The following table summarizes the different **refundable Investment Tax Credit (ITC)** rates. Again the rates vary depending on:

- the nature of the taxpayer - CCPC, non-CCPC, individual
- For CCPCs, and any associated corporations - the aggregate taxable income and taxable capital of the group in the previous year.

Nature of Taxpayer	ITC Refundable Rate
<p>For CCPCs with taxable income of \$200,000<sup>21</sup> or less and taxable capital of \$10,000,000 or less.</p> <p style="text-align: center;">- <b>Current</b> R&amp;D expenditures on which ITC was earned at the rate of 35%</p>	100%
<p>For CCPCs with taxable income of \$200,000 or less and taxable capital of \$10,000,000 or less.</p> <p style="text-align: center;">- <b>Capital</b> R&amp;D expenditures on which ITC was earned at the rate of 35%</p> <p style="text-align: center;">For all ITCs earned at the 20% rate - this would include ITCs earned by non-CCPCs and individuals</p>	40%

<sup>21</sup> The income threshold was increased from \$200,000 to \$300,000 in the 2003 Federal budget. Since the threshold is determined from the previous year's taxable income, the \$300,000 will generally start to apply to 2004 year ends.

### Table 3 - Taxation of R&D Expenditures

The following table provides a comparison of the tax treatment of a \$100 expenditure on direct salaries and wages in three cases. The table does not illustrate the benefit of deducting capital R&D expenses immediately in the current year.

For Taxation Years <u>Ending December 31, 2003</u>	Non- Qualifying <u>Expenditure</u>	Qualifying Expenditure Eligible for <u>the 35% ITC</u>	Qualifying Expenditure Eligible for <u>the 20% ITC</u>
Taxable Income before Expenditure	\$1,000.00	\$1,000.00	\$1,000.00
Expenditure	(100.00)	(100.00)	(100.00)
Federal ITC	-	51.98	29.70
OITC	-	16.50	16.50
Federal Taxable Income	<u>900.00</u>	<u>968.48</u>	<u>946.20</u>
Federal ITC	-	(51.98)	(29.70)
Ontario Taxable Income	<u>900.00</u>	<u>916.50</u>	<u>916.50</u>
Federal Tax (13.12%)	118.08	127.06	124.14
Federal ITC	-	(51.98)	(29.70)
Total Federal Tax	<u>118.08</u>	<u>75.08</u>	<u>94.41</u>
Ontario Tax (5.5%)	49.50	50.41	50.41
OITC	-	(16.50)	(16.50)
Total Ontario Tax	<u>49.50</u>	<u>33.91</u>	<u>33.91</u>
Total Combined Tax	<u>\$ 167.58</u>	<u>\$ 108.99</u>	<u>\$ 128.38</u>
<b>Tax Savings resulting from R&amp;D expenditures</b>	On \$100 of expense	<b><u>\$ 58.59</u></b>	<b><u>\$ 39.20</u></b>
<b>Tax Savings as a percentage of R&amp;D expenditure</b>		<b><u>58.59%</u></b>	<b><u>39.20%</u></b>
<b>Tax Savings as a percentage of total combined tax on a non-qualifying expenditures</b>		<b><u>34.96%</u></b>	<b><u>23.39%</u></b>

#### General Assumptions

- The corporation is a “small” CCPC carrying on business and the R&D activities are carried on in Ontario
- The corporation’s income is eligible for the federal and Ontario low rates of tax on small business
- The combined taxable incomes, taxable capital and combined R&D expenditures, of the corporation and any associated corporations, do not exceed \$200,000, \$10,000,000 and \$2,000,000 respectively.

#### Note

- As presented above in the table, the federal ITC and the OITC have been added to income in the current year. In actual fact, these credits are added to income in the year subsequent to the year in which they are claimed.